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Essay

International Tax as International Law

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I. INTRODUCTION

Is international tax law part of international law? To an international lawyer, the question posed probably seems ridiculous. Of course international tax law is part of international law, just like tax treaties are treaties. But to an international tax lawyer, the question probably seems less obvious, because most international tax lawyers do not think of themselves primarily as international lawyers (public or private), but rather as tax lawyers who happen to deal with cross-border transactions. And indeed, once one delves into the details, it becomes clear that in some ways international tax law is different from "regular" international law. For example, international tax lawyers talk about residence and source jurisdiction, not nationality and territoriality, and the different names also carry different content. And while tax treaties are indeed treaties, they are concluded differently than other treaties (for example, they are negotiated by Treasury, not the State Department), are subject to different modes of interpretation (the Vienna Convention on the Law of Treaties (VCLT)[1], the "bible" of the international lawyer, is rarely invoked), and in the United States are subject to a rather peculiar mode of unilateral change, the treaty override.

The purpose of this Essay is to introduce to the international lawyer the somewhat different set of categories employed by international tax lawyers, and explain the reasons for some of the differences. At the same time, I hope to persuade practicing international tax lawyers and international tax academics that their field is indeed part of international law, and that it would help them to think of it this way. For example, I believe that knowledge of the VCLT would help international tax lawyers in interpreting tax treaties and avoiding some common mistakes.

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[1] May 23, 1969, 1155 U.N.T.S. 331.

This Essay has five Sections. After this Introduction, Section II discusses international jurisdiction to tax and how it differs from traditional international law concepts of jurisdiction. The issues addressed in this Section are familiar to international tax lawyers but may be new and interesting for international lawyers. Section III discusses tax treaties and how they differ from regular treaties in both interpretation and modification. Here, international tax lawyers can learn from international lawyers, but also vice versa. Section IV discusses the difficult and much debated question whether there exists an international customary tax law. In this context it is international tax lawyers who have most to gain by listening to international lawyers. Section V concludes by returning to the question posed above, answering in the affirmative, and then summarizing the ways international tax lawyers and international lawyers can learn from each other.

II. Jurisdiction to Tax

The traditional grounds of jurisdiction to prescribe in international law are nationality ("the activities, interests, status, or relations of [a state's] nationals outside as well as within its territory")[2] and territoriality ("conduct that, wholly or in substantial part, takes place within [a state's] territory").[3] Territoriality is expanded to cover conduct outside a state's territory that has, or is intended to have, a "substantial effect" within its territory.[4] As detailed below, international tax law modifies both concepts to a significant extent, resulting primarily in expanding the scope of nationality jurisdiction.

A. *Individuals: Redefinition of Nationality Jurisdiction as Residence*

Nationality usually is understood as equivalent to citizenship. Except for the United States, however, almost no other country in the world claims the right to tax its citizens on foreign source income when they live permanently in another country. The United States insists on the right to tax its citizens on worldwide income no matter where they live.[5] The Supreme Court in *Cook v. Tait* upheld this principle because of the benefits the United States provides its citizens even if they live overseas.[6] But the opinion is weak, its underlying rationale is doubtful (are these benefits really so great?), and almost

[2] Restatement (Third) of Foreign Relations Law § 402(2) (1987).
[3] Id. § 402(1)(a).
[4] Id. § 402(1)(c).
[5] IRC §§ 1, 2(d), 7701(a)(30).
[6] 265 U.S. 47 (1924).

no other country follows the rule. Thus, although international law seems to sanction the U.S. practice (and the United States has written it into all its tax treaties), it seems a dubious rule to follow, and it has been criticized by academics.[7]

Instead, every country in the world (including the United States) has adopted a definition of nationality for tax purposes that is much broader than how nationality commonly is understood. That definition is residence, which usually implies mere physical presence in the country for a minimum number of days. In the United States, physical presence for 183 days in a given year generally is sufficient to subject an individual to taxing jurisdiction on her worldwide income for that year.[8] Even fewer days suffice if added to days spent in the United States in the previous two years.[9] Other countries follow a similar rule,[10] although they sometimes supplement it with a "fiscal domicile" test that looks to less bright line factors such as location of principal abode, family ties, and the like. The two tests (physical presence and fiscal domicile) also are incorporated into tax treaties.[11]

This definition is a remarkable expansion of the concept of nationality. I doubt there is another substantive area of international law in which nationality jurisdiction for individuals rests on so flimsy a ground as mere physical presence. In fact, because of this expansive view, it is easy to be subject to residence-based taxation by a country in one year and not in the next, and it is also easy for individuals to have dual tax residency. Elaborate rules are necessary to address situations in which individuals move in and out of resident status from year to year (for example, rules on deemed sales of their property when they leave[12]), and to avoid dual residence double taxation.[13]

Why has nationality-based jurisdiction been so expanded in tax law? The reason is easy to see if one considers the implications of the relative ease of acquiring a tax haven nationality. If tax law followed the general international law rule and imposed worldwide taxation only on citizens, then a lot of U.S. citizens would abandon their citizenship in exchange for that of some Caribbean tax haven jurisdiction,

[7] See, e.g., Brainard L. Patton, Jr., United States Individual Income Tax Policy as It Applies to Americans Resident Overseas: Or, If I'm Paying Taxes Equal to 72 Percent of My Gross Income, I Must Be Living in Sweden, 1975 Duke L.J. 691; Note, Section 911 Tax Reform, 54 Minn. L. Rev. 823 (1969-1970).

[8] IRC § 7701(a)(30), (b).

[9] IRC § 7701(b)(3).

[10] E.g., William H. Newton, III, International Income Tax and Estate Planning § 5:40 (2d ed. 2004) (discussing similar rule of, among others, Austria, Denmark, France, and Germany).

[11] Id.

[12] E.g., IRC § 877.

[13] E.g., IRC § 7701(b)(2) (setting out rules for the first and last year of residence).

and thereby avoid taxation on their foreign source income while living permanently in the United States. In general, living in a country for over one-half year is considered a sufficient ground for worldwide taxation because of the presumed benefits derived from that country.

The residence rule is so widely followed and incorporated into so many treaties that it can be considered part of customary international law, even though it seems contrary to widely shared understandings of nationality.[14] It is thus appropriate for the United States to follow this rule. It is doubtful, however, whether the United States should continue to insist on taxing its citizens living overseas, especially since because of a combination of exemptions and credits (and enforcement difficulties) it collects little tax from them.[15]

B. *Corporations: Expansion of Nationality Jurisdiction to CFCs*

The nationality of a corporation is a thorny issue, which comes up in other areas of the law as well. In general, corporations are considered nationals based either on the country in which they are incorporated (the U.S. approach), or the country from which they are managed and controlled (the U.K. approach), or both.[16] Each approach has its advantages and disadvantages; the U.S. approach is the easiest to administer but also the most manipulable, as shown recently by so-called inversion transactions in which corporations shifted their nominal country of incorporation to Bermuda while retaining all of their headquarters and management in the United States.[17] The U.K. approach is manipulated less easily but requires more administrative resources to police.

The interesting aspect of nationality jurisdiction for corporations in tax law is the gradual adoption of a rule that permits countries to tax "controlled foreign corporations" (CFCs), that is, corporations controlled by nationals, as if they were nationals themselves. This rule originated with the United States.[18] Because the definition of corporate nationality in the United States is formal (country of incorporation),[19] it is easy for U.S. nationals (residents) who have foreign source income to avoid taxation on such income by shifting it to a corporation incorporated in another country, preferably a tax haven,

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[14] See Section IV.

[15] See, e.g., IRC §§ 901, 911-912.

[16] See, e.g., Rev. Rul. 72-378, 1972 C.B. 662 (noting that countries can base corporate residence on place of incorporation or on place of management and control); Finance Act, 1989, § 249 (Eng.).

[17] See, e.g., Hal Hicks, III, Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives, 30 Tax Notes Int'l 899, 905 (June 2, 2003).

[18] See text accompanying notes 21-23.

[19] IRC § 7701(a)(4).

where it can accumulate tax free. For example, Jacob Schick, the inventor of the Schick disposable razor, transferred his patent to it to a Bermuda corporation that accumulated the royalties. Schick later proceeded to retire to Bermuda, gave up his U.S. citizenship, and lived on the accumulated tax-free profits.[20]

To address this problem, in 1937 the United States adopted a rule that taxed shareholders of "foreign personal holding corporations" (FPHCs).[21] A FPHC was defined as a foreign corporation controlled (over 50% by vote) by five or fewer U.S. resident individuals, and whose income was over 60% passive (since passive income was considered easier to shift than active income).[22] Interestingly, at the time, the United States considered it a breach of international law to tax a FPHC (a foreign national) directly on foreign source income;[23] instead, it adopted a rule that taxed the U.S. shareholders on a deemed dividend of the accumulated passive income of the FPHC.[24] This rule can be compared to the personal holding company (PHC) regime adopted at the same time, which applied to domestic corporations and taxed them directly on their accumulated income at the shareholder rate (PHCs were used by shareholders to shelter U.S. source income from the higher individual rate by earning the income through a corporation subject to tax at a lower rate).[25]

Judge Frank of the Second Circuit upheld the deemed dividend rule without paying any attention to its international law implications.[26] And yet, it clearly represented a major expansion of U.S. residence taxing jurisdiction, since taxing a deemed dividend is economically equivalent to taxing a foreign corporation directly on foreign source income. It certainly could be argued that in 1943 this rule was a breach of international law, just like Judge Hand's antitrust decision in *United States v. Aluminum Co. of America*,[27] which invented the effects doctrine, was likewise arguably a breach of international law.[28]

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[20] Tax Evasion and Avoidance: Hearings Before the Joint Comm. on Tax Evasion and Avoidance, 75th Cong. 63 (1937).

[21] See Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 SMU L. Rev. 445, 475 (1999); H.R. Rep. No. 75-1546, at 13-14 (1937), excerpted in J.S. Seidman, Seidman's Legislative History of Federal Income Tax Laws, 1938-1961, at 189 (1938).

[22] See Peroni, et al., note 21, at 476.

[23] See Reuven S. Avi-Yonah, The Deemed Dividend Problem, 4 J. Tax'n Global Transactions 33, 34 (2004) [hereinafter Deemed Dividend Problem].

[24] Revenue Act of 1937, Pub. L. No. 75-377, §§ 331-341, 50 Stat. 813, 1731.

[25] Revenue Act of 1937, Pub. L. No. 75-377, §§ 351-360, 50 Stat. 813, 1732.

[26] Eder v. Commissioner, 138 F.2d 27, 28-29 (2d Cir. 1943).

[27] 148 F.2d 416 (2d Cir. 1945).

[28] See Roger P. Alford, The Extraterritorial Application of Anti-Trust Laws: The United States and European Community Approaches, 33 Va. Int'l L. 1, 42 (1999).

The impact of the deemed dividend rule was greatly expanded when the Kennedy administration decided in 1961 to propose applying the same rule to all income of corporations that are over 50% controlled by large (10% by vote each) U.S. shareholders, that is, to subsidiaries of U.S multinationals (CFCs).[29] Ultimately, this resulted in the enactment in 1962 of subpart F, which applied the deemed dividend rule to certain types of income (mostly passive income) of all CFCs.[30]

Again, there was no international law challenge to the deemed dividend rule. Instead, other countries began to copy the CFC regime: Germany in 1972,[31] Canada in 1976,[32] Japan in 1978,[33] France in 1980,[34] and the UK[35] in 1984. Currently, there are 23 countries with CFC rules (mostly developed ones),[36] and the number is likely to increase. Thus, it would seem that the CFC concept arguably has become part of customary international law, just like the expansion of territorial jurisdiction over international waters rapidly changed international law from the 1970's onward.

Even more striking is the fact that many of the countries adopting the CFC rule abandoned the deemed dividend idea, which can lead to significant difficulties in practice, in favor of direct taxation of the CFC's shareholders on its earnings on a pass-through basis.[37] Thus, the jurisdictional rule has been changing and no longer seems to require a deemed dividend, and may even permit direct taxation of a CFC on its foreign source income because it is controlled by residents. Indeed, the Service itself has adopted this view, because it now believes that both the PHC regime, as well as the older accumulated earnings tax regime, apply directly to foreign corporations even though their effect is to tax the corporation on foreign source income.[38] This is particularly striking for PHCs, because it was so clear in 1937 that the United States had no jurisdiction to tax foreign corporations on foreign source income that Congress did not bother to specify that a PHC could not be a foreign corporation (while at the same time adopting the parallel FPHC regime explicitly for foreign corpora-

29 See Peroni et al., note 21, at 476.

30 Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (adding IRC §§ 951-964).

31 OECD, Controlled Foreign Company Legislation 22 (1996).

32 Id. at 23.

33 Id. at 23.

34 Id. at 24.

35 Id.

36 See Brian J. Arnold, General Report, Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, 86b Cahiers de Droit Fiscal Int'l (2001).

37 Avi-Yonah, Deemed Dividend Problem, note 23, at 35-38.

38 Rev. Rul. 60-34, 1960-1 C.B. 203; see IRC § 542(c)(7); Reg. § 1.532-1(a).

tions).[39] Now this oversight enables the Service to argue that under the new understanding of jurisdictional limits, the PHC rules as well as the FPHC rules apply to foreign corporations.

Claiming that nationality jurisdiction applies to foreign corporations just because they are controlled by nationals is a striking departure from ordinary international law. Compare, for example, the oft-recurring disputes about the extraterritorial application of international sanctions. In both *Fruehauf*[40] and *Sensor*[41], the foreign courts explicitly rejected U.S. claims to require foreign subsidiaries of U.S. multinationals to obey U.S. sanctions aimed at China and the USSR, respectively. In *Sensor*, the Dutch court went through all the possible grounds for jurisdiction and explicitly found that none applied.[42] It was clear that nationality jurisdiction did not apply even though the subsidiary was controlled from the United States.

What, then, enables the United States and other countries to expand nationality jurisdiction to subsidiaries in the tax area? The explanation is the "first bite at the apple rule," adopted by the League of Nations in 1923.[43] Under that rule, the source (territorial) jurisdiction has the primary right to tax income arising within it, and the residence (nationality) jurisdiction is obligated to prevent double taxation by granting an exemption or a credit. Thus, permitting the expansion of residence jurisdiction to CFCs does not harm the right of source jurisdictions to tax them first; residence (nationality) jurisdiction only applies as a residual matter when the source jurisdiction abstains from taxing. This still leads sometimes to complaints by source jurisdictions that the residence jurisdiction is taking away their right to effectively grant tax holidays to foreign investors,[44] but the restricted application of CFC rules to passive income mitigates even that.

In general, I believe this story is a good illustration of the growth of customary international law in the tax area. In the 1930's-1960's pe-

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39 See Avi-Yonah, Deemed Dividend Problem, note 23. As a result, the FPHC regime and the PHC regimes were duplicative, as well as redundant in light of the later PFIC regime, and both were repealed (FPHC completely, PHC for foreign corporations) in the American Jobs Creation Act of 2004, Pub. L. No. 108-35, § 413.

40 Fruehauf Corp. v. Massardy Cours D'Appel Paris, May 22, 1965, Gaz Pal 1965 (France), translated in 5 I.L.M. 476 (1966).

41 Compagne Europeénne des Petroles, SA v. Sensor Nederland, BV, Distr Ct, The Hague, Sept. 17, 1982, 36 Rechtspraak van de Week-Kort Geding 167, translated in 22 I.L.M. 66 (1983).

42 Id. at 70-74.

43 Report on Double Taxation, Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, League of Nations Doc. No. E.F.S. 73.F.19 (1923), reprinted in 4 Staff of Joint Comm. on Tax'n, Legislative History of United States Tax Conventions 4003 (1962).

44 See, e.g., Antonio Figueroa, Tax Treaties and International Investment Flows, Taxation and International Capital Flows 93-97 (1990).

riod, there was a clear rule of customary international law that prohibited taxing foreign corporations on foreign source income. That rule was observed universally and was considered binding, as illustrated by the United States using the deemed dividend mechanism to avoid an outright breach. Once, however, a lot of countries changed the rule by taxing shareholders directly on CFC income, the United States no longer considered it binding, as indicated by applying the PHC regime to foreign corporations.[45] The next step for the United States would be to abolish the obsolete deemed dividend rule and replace it by a direct tax on the CFCs.

C. *The Problem of Territorial Jurisdiction (Source)*

The right of countries to tax income arising in their territory is well established in international law. In fact, some countries (for example, France) begin with the assumption that the only income they have the right to tax is domestic source income, although France and other territorial jurisdictions have long since begun to tax some income of nationals from foreign sources.[46] And even countries that begin with worldwide taxation of nationals, like the United States and the UK, in practice do not tax foreign source income as heavily.

The special problem of territoriality in the tax area is that the source of income is very difficult to define. In fact, most public finance economists would deny that it is a meaningful concept in the majority of cases.[47] Think of a law firm in country *A* that provides advice on the legal implications of a merger of two multinationals whose parents are in countries *A* and *B* and whose operations are in 20 countries around the globe. What is the economic source of the law firm's income?

Ideally, one could imagine a world in which all countries tax only on a nationality (residence) basis, and the only problem would be assigning residence to individuals (not too hard) and to corporations (quite difficult). But in practice, as long as countries desire to tax nonresidents on domestic source income, as they have every right to do under international law, the problem of defining source would persist.

To some extent the problem has been solved by arbitrary rules embodied in tax treaties that define the source of various categories of

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[45] See Revenue Act of 1934, Pub. L. No. 73-216, § 351, 48 Stat. 680, 751–52 (adding PHC regime).

[46] Hugh J. Ault & Brian J. Arnold, Comparative Income Taxation: A Structural Analysis 379, 389 (2d ed. 2004).

[47] Hugh J. Ault & David F. Bradford, Taxing International Income: An Analysis of the U.S. System and Its Economic Premises, 14 Tax'n in the Global Economy 11, 31-32 (Assaf Razin & Joel Slemrod eds., 1990).

income (and that in my view may form part of customary international law). For example, income from services is sourced where the services are provided (and not where they are consumed); dividend and interest income are sourced by the residence of the payor; capital gains are sourced by the residence of the seller; and so on.[48] The difficulty then becomes deciding which category income falls into, which is sometimes very hard (consider for example how to distinguish between sales, services, and royalty income when downloading software off the internet, buying it in a store, or receiving it in a pre-installed package on a PC).

In the case of multinationals, the sourcing issue becomes even harder because taxing them requires allocating the income of a controlled group of corporations among taxing jurisdictions. If tax authorities merely followed the form (regarding which subsidiary nominally earned the income from intergroup transactions), all income of multinationals would be booked in tax haven subsidiaries. A whole branch of tax law called transfer pricing is devoted to resolving this problem.[49] In Section IV, I return to this point, because it provides a good illustration of customary international tax law.

The main point here is simply that territoriality, which is a relatively easy concept to define in international law in general, becomes very hard when tax law is concerned. And it may be a pity that international law makes it so easy to tax foreigners on a territoriality basis, although as long as one wants to tax corporations, I suspect that source-based taxation is inevitable (since the residence of corporations is inherently more manipulable and less meaningful than the residence of individuals).

III. Tax Treaties

A. *Treaty Interpretation and the VCLT*

Tax treaties are, of course, treaties: They are considered by the Senate Foreign Relations Committee (and not the Finance Committee) and ratified by the Senate just like any other treaty.[50] But they are also unlike other treaties. First, they are negotiated by the International Tax Counsel in Treasury's Office of Tax Policy, not by the State Department. Second, their interpretation is governed primarily by the Technical Explanation,[51] which likewise is drafted by Treasury

[48] See generally Joel D. Kuntz & Robert J. Peroni, U.S. International Taxation ¶ A2.03 (2002).

[49] See, e.g., IRC § 482.

[50] U.S. Const. art. II, § II, cl. 2.

[51] E.g., Treas. Dep't, Technical Explanation of the Canada-U.S. 1995 Protocol, 1 Tax Treaties (CCH) ¶ 1951 (June 13, 1995).

and not by State. And finally, the ways tax treaties are interpreted differ markedly from the interpretation of other treaties.

The biggest difference relates to the role of the VCLT. David Bederman writes that "[t]he VCLT is, quite literally, a treaty on treaties. Almost every question of treaty law is settled in that document, and it is an essential bit of reading for every international lawyer."[52] But not for the international tax lawyer. A search of the tax cases database in LEXIS revealed among hundreds of treaty interpretation cases only one quite recent case in which a court discussed the potential application of the VCLT.[53]

It is true, of course, that the United States signed but never ratified the VCLT;[54] but this does not prevent U.S. international lawyers from relying on it in nontax contests as embodying customary international law (in fact, having signed the VCLT, the United States is supposed not to act contrary to it[55]). Rather, the lack of reference to the VCLT in tax treaty cases simply results from the fact that most tax lawyers have never heard of it. Instead, they rely for example on the OECD commentary on the OECD model tax treaty,[56] which frequently is cited in treaty interpretation cases.[57]

This sometimes can lead to unfortunate, even bizarre, results. For example, article 31 of the VCLT states a general rule that treaties should be interpreted "in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose."[58] "Context" for this purpose includes any subsequent protocols and contemporaneous instruments relating to the treaty, and subsequent practice relating to implementation.[59] Article 32 of the VCLT states that as supplementary sources recourse may be had to "preparatory work of the treaty and the circumstances of its conclusion . . . ," but only "to confirm the meaning resulting from the application of article 31, or to determine the meaning when interpretation according to article 31: (a) [l]eaves the meaning ambiguous or obscure; or (b) [l]eads to a result which is manifestly absurd or unreasonable."[60]

52 David J. Bederman, International Law Frameworks 26 (2001).

53 Kappus v. Commissioner, 337 F.3d 1053 (D.C. Cir. 2003).

54 Restatement, note 2, at 144-45.

55 VCLT, note 1, at 336.

56 OECD, Model Convention With Respect to Taxes on Income and on Capital, Jan. 28, 2003, available at www.oecd.org/dataoecd/52/34/1914467.pdf; 1 OECD, Model Tax Convention on Income and on Capital (2000).

57 See, e.g., Taisei Fire and Marine Ins. Co. v. Commissioner, 104 T.C. 535, 548 (1995).

58 VCLT, note 1, at 340.

59 Id.

60 Id.

Now consider the case of *Xerox Corporation v. United States*.[61] That case involved a highly technical question on the interpretation of the 1975 U.S.-U.K. tax treaty. The Court of Claims found support for the Service's view in (1) the language of the treaty itself, (2) the contemporaneous technical explanation, (3) IRS practice as evidenced by a revenue procedure, and (4) a subsequent agreement between the competent authorities designed to settle the matter.[62] The Court of Appeals chose to ignore all of those sources and relied instead on affidavits submitted to it by the treaty negotiators as to what they meant.[63] It is hard to imagine such a result under the VCLT, since all the article 31 sources supported the Service, and the affidavits (at best article 32, and therefore inferior, sources) were not even contemporaneous with the treaty but executed years later when the affiants were in private practice and had no stake in protecting the fisc. Not surprisingly, it is hard to defend the result in *Xerox* from a pure tax perspective either; the general consensus is that the corporation "got away with murder."

My point here is simply that it would be a good idea for international tax lawyers to study the VCLT. A lot of hard thinking went into that treaty, and it should not lightly be ignored.

B. *Treaty Overrides*

The most notorious difference between tax treaties and other U.S. treaties is the frequency of treaty overrides (other treaties are overridden, but much less frequently). Under international law, pacta sunt servanda; "[e]very treaty in force is binding upon the parties and must be performed by them in good faith. . . A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."[64]

Under U.S. law, however, treaties are, under the Supremacy Clause of the Constitution, equal in standing to regular laws.[65] Therefore, at least as interpreted by the Supreme Court, the general rule of later in time controls.[66] In the tax context, § 7852(d) embodies this rule, and states that "[f]or purposes of determining the relationship between a provision of a treaty and any law of the United States affecting reve-

[61] 41 F.3d 647 (Fed. Cir. 1994).

[62] Xerox Corp. v. United States, 14 Cl. Ct. 455, 462-66 (1988).

[63] *Xerox*, 41 F.3d at 654.

[64] VCLT, note 1, at 339.

[65] U.S. Const. art. VI, cl. 2.

[66] Whitney v. Robertson, 124 U.S. 190, 194-95 (1888); Breard v. Greene, 523 U.S. 371, 376 (1998).

nue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law."

Of course, this unique U.S. interpretation applies to all U.S. treaties, not just to tax treaties. But at least in recent years, its clearest manifestation has been in the tax area. The reason that tax is particularly sensitive in this context is first, that tax law changes all the time while treaties are slow to renegotiate, and second, that the U.S. House of Representatives has a special role to play in the tax area (all revenue measures must originate with it[67]), but is excluded from involvement with treaties, and therefore insists on its right to change tax treaties through legislation even though this clearly violates customary international law as embodied in the VCLT.

But the interesting question is, when does the United States resort to treaty overrides? The answer is rarely, and when it does so deliberately, an argument can be made that it is justified in doing so. Consider three recent cases from the period 1986-1997: the branch profits tax, the earnings stripping rule, and the reverse hybrid rule.[68]

The branch profits tax (BPT) was enacted in 1986[69] to equalize the positions of foreign investors who operate in the United States through a subsidiary and through a branch.[70] Before 1986, investors who operated through a subsidiary were subject to tax on the subsidiary's income and also to a withholding tax on dividends, whereas investors who operated through a branch were subject only to a tax on the branch income because distributions from the branch were not dividends and were not subject to withholding tax.[71] Under the new rule, the earnings and profits attributable to a U.S. branch of a foreign corporation were subject to the BPT.[72] But a problem arose: Many U.S. tax treaties prohibited taxing distributions to foreign shareholders from foreign corporations resident in a treaty country even if the distribution came out of the earnings of a U.S. branch.[73] Arguably the BPT violated the spirit of this rule (although not its letter). So did the United States resort to treaty override? It did not. Instead, it announced that the BPT would not apply to residents of those treaty countries until the treaties were renegotiated to permit the BPT.[74] In

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67 U.S. Const. art. I, § 7, cl. 1.

68 IRC §§ 884, 163(j), 894(c).

69 Tax Reform Act of 1986, Pub. L. No. 99-514, § 1241, 100 Stat. 2085, 2576-81.

70 See H.R. Conf. Rep. No. 99-841, at II-647, reprinted in 1986-3 C.B. (vol. 4) 647.

71 See Staff of the Joint Comm. on Tax'n, 100th Cong., General Explanation of the Tax Reform Act of 1986, at 1035-45 (Comm. Print 1987).

72 See IRC § 884(c).

73 See S. Rep. No. 99-313, at II-402, reprinted in 1986-3 C.B. (vol. 3) 402.

74 See id. at II-404—II-405.

fact, by now most U.S. treaties have been so renegotiated,[75] and other countries have adopted a branch profits tax in their own laws.[76]

But this left the United States in a difficult position, because while treaties were slowly renegotiated, it could collect the BPT on some branches but not on others. At the time, there were no limitation-on-benefits provisions in U.S. treaties, leading to a concern that there would be widespread treaty shopping (by, for example, setting up a corporation in a treaty jurisdiction just to benefit from the treaty). So the United States inserted a limitation-on-benefits provision into the BPT rule in the Code and made that an explicit treaty override.[77] Was it justified? I believe that an underlying assumption of treaties is that they are intended to benefit only bona fide residents (otherwise, any treaty becomes a "treaty with the world"). Thus, I think the override was justified because it is consistent with the underlying purpose of the treaties. But countries like the Netherlands that later negotiated much longer limitation-on-benefits provisions[78] that were full of loopholes may have had reason to be miffed, because they derive revenue by letting their treaties be used for treaty shopping.

Next, consider the earnings stripping rule, adopted in 1989.[79] That rule is a "thin capitalization" provision; thus, it is intended to prevent foreign parents from eliminating the tax base of their U.S. subsidiaries (or branches) through interest deductions by capitalizing them mostly with debt rather than equity.[80] When Congress adopted the rule, it was concerned that the rule would appear to be a violation of the nondiscrimination provision in tax treaties if it applied only to foreign related parties.[81] Thus, to avoid even the appearance of a treaty override, the United States instead applied the rule to all "tax exempt related parties"—that is, to domestic tax-exempts as well as foreigners.[82] But this was an obvious ruse, since no domestic tax-exempts are ever related (that is, control over 50%) to domestic taxable subsidiaries. Nor do I believe the ruse was necessary, because most countries have a thin capitalization rule and apply it explicitly to foreigners.[83] I thus

[75] See, e.g., Income Tax Convention, Dec. 18, 1992, U.S.-Neth., art. 11, 3 Tax Treaties ¶ 6103.12 (branch profits tax).

[76] See Ault & Arnold, note 46, at 410-11 (Canada, France, and Australia).

[77] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1241, 100 Stat. 2085, 2578; IRC § 884(e)(1)(B) (restricting treaty benefits to foreign corporations that are "qualified residents" of the treaty partner within the meaning of IRC § 884(e)(4)).

[78] See U.S.-Neth. Treaty, note 75, art. 26, 3 Tax Treaties (CCH) ¶ 6103.28.

[79] Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7210, 103 Stat. 2106, 2339-42 [hereinafter OBRA] (adopting IRC § 163(j)).

[80] See generally H.R. Conf. Rep. No. 101-386, at 564-71, reprinted in 1989-3 C.B. (vol. 5) 564-71.

[81] See id. at 568-69.

[82] OBRA, note 79, § 7210, 103 Stat. at 2340.

[83] Ault & Arnold, note 46, at 412-14 (Canada, Australia, U.K., Japan, and Germany).

believe thin capitalization is an accepted customary international law exception to nondiscrimination, which is necessary because the source country has the primary right to tax active business income and without a thin capitalization rule that base easily can disappear. What is striking, though, is how reluctant the United States was to override treaties.

Finally, consider the reverse hybrid rule, adopted by the United States as a treaty override in 1997.[84] The rule was adopted in response to a transaction in which a Canadian parent set up a limited liability company in the United States and capitalized it with what was equity for Canadian purposes but debt for U.S. purposes.[85] The United States treated the LLC as a branch but Canada treated it as a subsidiary. The result was that, from a U.S. perspective, the tax on the branch was offset by interest deductions on the debt with a reduced rate of withholding tax under the treaty, but from a Canadian perspective, the income was treated as exempt dividends from a controlled subsidiary: hence double nontaxation. The United States could have (and indeed later did) renegotiate the treaty, but this takes time, and a lot of revenue was being lost. Hence the treaty override, to which Canada did not object, denied treaty benefits to such a "reverse hybrid." Fundamentally, I believe the override was justified because the purpose of tax treaties is to prevent double taxation and not to enable double nontaxation; reductions of tax at source should be premised on taxation by the residence jurisdiction.

In each of these cases I think an override was justified. The reality is that tax law and practice change too fast to wait for treaties to be renegotiated. Still, overrides should be used sparingly and only when consistent with the underlying purpose of the treaty. And there are unjustified overrides, such as the provision of the alternative minimum tax that limits the foreign tax credit to 90%.[86] That leads directly to double taxation and is not justifiable in the treaty context, but courts (including recently the D.C. Circuit[87]) have accepted it as a valid override (even though Congress did not explicitly designate it as such).

IV. Is There a Customary International Tax Law?

Customary international law is law that "results from a general and consistent practice of states followed by them from a sense of legal

[84] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1054(a), 111 Stat. 788, 943-44 (adopting IRC § 894(c)).

[85] See H.R. Rep. No. 105-148, at 550-51, reprinted in 1997-4 C.B. (vol. 1) 872-73.

[86] See IRC § 59(a)(2).

[87] See, e.g., Kappus v. Commissioner, 337 F.3d 1053 (D.C. Cir. 2003).

obligation."[88] "International agreements create law for states parties thereto and may lead to the creation of customary international law when such agreements are intended for adherence by states generally and are in fact widely accepted."[89]

There clearly are international tax practices that are widely followed, such as avoiding double taxation by granting an exemption for foreign source income or a credit for foreign taxes. Moreover, there are over 2,000 bilateral tax treaties in existence,[90] and they all follow one of two widely accepted models (the OECD and UN model treaties),[91] which themselves are quite similar to each other and are "intended for adherence by states generally."[92] Is this enough to create a customary international tax law?

International tax lawyers hotly debate this question, although usually it is not couched in these terms. Instead, the debate is about whether countries are bound by an "international tax regime" or "international tax system," or whether international tax is only about the law adopted by each country and the treaties to which it binds itself.[93] Specifically, the debate is about international tax arbitrage, for example, transactions that utilize differences between tax laws to achieve double nontaxation. On the one side are those who argue that there is nothing wrong with tax arbitrage since there is no international tax regime and each country is free to do as it likes, so taxpayers are also free to exploit differences.[94] On the other hand are those who argue that countries are not so free and that a coherent international tax regime does exist.[95] The debate is in part about specific provisions in U.S. law that are designed to prevent double nontaxation, such as the dual consolidated loss rules (which prevent taxpayers from claiming the same loss to offset income in two taxing jurisdictions).[96] If there is no international tax regime, such rules make no sense. Similarly, rules such as those promulgated by Treasury in 1998, which prevent taxpay-

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88 Restatement, note 2, § 102(2).

89 Id. § 102(3).

90 Victor Thuyroni, In Defense of a Multilateral Tax Treaty, 22 Tax Notes Int'l 1291, 1291 n.3 (Mar. 12, 2001).

91 OECD Model Treaty, note 56; UN, Model Double Taxation Convention Between Developed and Developing Countries, 1980, 1 Tax Treaties (CCH) ¶ 206.

92 Restatement, note 2, § 102(2).

93 See, e.g., H. David Rosenbloom, International Tax Arbitrage and the "International Tax System," The David R. Tillinghast Lecture, NYU School of Law (Oct. 1, 1998), in 53 Tax L. Rev. 137, 163-64 (2000); Reuven S. Avi-Yonah, Comment, 53 Tax L. Rev. 167, 169 (2000) [hereinafter Comment]; Yariv Brauner, An International Tax Regime in Crystallization, 56 Tax L. Rev. 259, 308 (2003).

94 See, e.g., Rosenbloom, note 93.

95 See, e.g., Avi-Yonah, Comment, note 93.

96 See IRC § 1503(d).

ers from using tax arbitrage to reduce foreign taxes are very controversial.[97]

In the following, I briefly survey some examples that in my opinion strengthen the view that an international tax regime does exist and that it rises to the level of customary international law. As usual, the hard question is whether countries not only follow a rule but do so out of a sense of legal obligation (opinio juris).

A. *Jurisdiction to Tax*

Can a country simply decide to tax nonresidents that have no connection to it on foreign source income? The answer is clearly no, both from a practical perspective and, I would argue, from a customary international law perspective. The behavior of the United States in adopting the FPHC and CFC rules[98] illustrates that this rule is followed from a sense of legal obligation. The United States adopted the deemed dividend rule precisely because it felt bound by a customary international law rule not to tax nonresidents directly on foreign source income, even though they are controlled by residents.[99] The United States no longer feels bound by this rule, but that is because enough other countries have adopted CFC legislation that expands the definition of nationality that customary international law has changed.[100] The spread of CFC legislation is a good example of how rapidly customary international law, in fact, can change.

B. *Nondiscrimination*

The nondiscrimination norm (that is, that nonresidents from a treaty country should not be treated worse than residents) is embodied in all tax treaties.[101] But is it part of customary international law? The behavior of the United States in the earnings stripping episode suggests that at the time the United States felt that the nondiscrimination norm was binding even outside the treaty context. Otherwise, even if it did not wish to override treaties, it could have applied a different rule to nontreaty country residents (as it did in the branch profits tax context three years earlier). Thus, I would argue that the

[97] Rev. Rul. 98-11, 1998-1 C.B. 645; Rev. Rul. 98-35, 1998-2 C.B. 89.

[98] See text accompanying notes 21-30.

[99] President's Tax Message Along With Principal Statement, Detailed Explanation, and Supporting Exhibits and Documents: Hearing on H.R. 1447 Before the House Comm. on Ways and Means, 87th Cong. 52 (1961) (statement of Douglas Dillon, Treas. Sec'y).

[100] Ault & Arnold, note 46, at 380-86 (Canada, Japan, Sweden, U.K., Germany, and Australia).

[101] OECD Model Treaty, note 56, at 24.

nondiscrimination norm in fact may be part of customary international law even in the absence of a treaty.

C. The Arm's Length Standard

The standard applied in all tax treaties to the transfer pricing problem of determining the proper allocation of profits between related entities is the "arm's length standard,"[102] which means that the tax authorities may adjust transactions between related parties to the terms that would have been negotiated had the parties been unrelated. This standard has been the governing rule since the 1930's.[103]

In the 1980's, the United States realized that in many circumstances it is very difficult to find comparable transactions between unrelated parties on which to base the arm's length determination.[104] It therefore began the process of revising the regulations that govern transfer pricing.[105] This culminated in 1995 with the adoption of two new methods, the comparable profit method and profit split method, that rely much less on finding comparables (and in the case of the profit split method sometimes require no comparables at all).[106]

What is remarkable about the process by which these regulations were adopted is the U.S. insistence throughout that what Treasury was doing was consistent with the arm's length standard. It even initially called the profit split method the "basic arm's length return method."[107] But as I have pointed out elsewhere, once you abandon the search for comparables, it is meaningless to call a method arm's length, because without comparables nobody can know what unrelated parties would have done.[108]

Nevertheless, despite initial objections,[109] the OECD ultimately came to accept the gist of the new methods in its revised transfer pricing guidelines, which were issued a short time after the new U.S. regulations and represent the widely-followed consensus view of transfer pricing.[110] The new methods thus are accepted under the rubric of arm's length.

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[102] Reuven S. Avi-Yonah, The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation, 15 Va. Tax Rev. 89, 89 (1995) [hereinafter Rise and Fall]; Notice 88-123, 1988-2 C.B. 458, 475.

[103] Avi-Yonah, Rise and Fall, note 102, at 97.

[104] Id. at 112-29.

[105] Id. at 129-36.

[106] Reg. §§ 1.482-5 (comparable profit method), -6 (profit split method).

[107] Notice 88-123, 1988-2 C.B. 458, 489.

[108] Avi-Yonah, Rise and Fall, note 102, at 134-35.

[109] See, e.g., Kathleen Matthews, Major U.S. Trading Partners Respond to U.S. Transfer Pricing Regulations, 94 TNI 205-3 (Oct. 24, 1994), available in LEXIS, Tax Analysts File.

[110] See OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995).

As Brian Lepard has suggested, the insistence by the United States that it was following the arm's length standard indicates that it felt that the standard is part of customary international law.[111] Such a finding has important implications because the U.S. states explicitly follow a non-arm's length method, formulary apportionment, which the U.S. Supreme Court has upheld twice.[112] If the arm's length method is customary international law, these cases may have been wrongly decided, as customary international law is part of federal law and arguably preempts contrary state law.[113]

D. *Foreign Tax Credits vs. Deductions*

Many economists argue that countries should give only a deduction for foreign taxes rather than a credit.[114] Countries, however, generally grant either an exemption for foreign source income or a credit for foreign taxes paid.[115] Remarkably, in most cases (following the lead of the United States) this is done even in the absence of a treaty.[116] It is likely that at this point countries consider themselves in practice bound by the credit or exemption norm, and a country would feel highly reluctant to switch to a deduction method instead. Thus, arguably preventing double taxation through a credit or exemption has become part of customary international law.

E. *Conclusion*

If customary international tax law exists, this has important implications for the United States and other countries. As Justice Gray wrote over a century ago in the *Paquete Habana* case,

> [I]nternational law is part of our law, and must be ascertained and administered by the courts of justice of appropriate jurisdiction, as often as questions of right depending upon it are duly presented for their determination. For this purpose, where there is no treaty, and no controlling execu-

[111] Brian D. Lepard, Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry Into the Normative Authority of Contemporary International Law Using the Arm's Length Standard as a Case Study, 10 Duke J. Comp. & Int'l L. 43, 57-58 (1999).

[112] Barclays Bank PLC v. Franchise Tax Bd. of Cal., 512 U.S. 298 (1994); Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983).

[113] Restatement, note 2, § 111(1).

[114] See, e.g., Eric W. Bond & Larry Samuelson, Strategic Behaviour and the Rules for International Taxation of Capital, 99 Econ. J. 1099 (1989).

[115] See Michael J. Graetz & Paul W. Oosterhuis, Structuring an Exemption System for Foreign Income of U.S. Corporations, 54 Nat'l Tax J. 771, 771 (2001).

[116] E.g., IRC § 901.

> tive or legislative act or judicial decision, resort must be had to the customs and usages of civilized nations . . . .[117]

To the extent legislation exists, in the United States it can override customary international law as well as treaties.[118] But in the absence of treaties or legislation, resort can be had to customary international law; and I would argue that it also can be used to ascertain the underlying purposes of treaties.

To the extent that customary international tax law exists, this suggests that it is a mistake to deny the existence of an international tax system or regime. Admittedly, even if an international tax regime exists, we do not know what we should do about it; this has to be investigated in each particular case. But we should not pretend that there are no binding, widely-accepted international tax norms that we should flout only when significant national interests are at stake.

V. Conclusion

Clearly, international tax law is part of international law, even if it differs in some of its details from generally applicable international law. I believe both international lawyers and international tax lawyers can benefit from viewing international tax law in this way. For international lawyers, the tax field is an interesting arena to test some of their ideas. It offers them a different view of nationality and territoriality jurisdiction, which perhaps can be profitably carried over into other fields (I believe it would help, for example, to take control generally into account in determining the nationality of corporations). It also offers interesting examples of how customary international law can change rapidly, as in the CFC case.[119] Finally, it suggests that even a basic rule like pacta sunt servanda sometimes may have its exceptions if one wishes to preserve the rationale of the underlying treaty.

I believe, however, that it is international tax lawyers who can benefit the most from viewing their field as part of international law. For example, knowing the VCLT can prevent mistakes such as those committed in *Xerox*.[120] And understanding that international tax law can be seen in significant part as customary international law can help clarify some of the constraints facing a country like the United States as it struggles to adapt its international tax laws to the business realities of the 21st century.

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117 The Paquete Habana, 175 U.S. 677, 700 (1900).
118 Restatement, note 2, § 115(1)(a).
119 See Section II.B.
120 See note 62 and accompanying text.